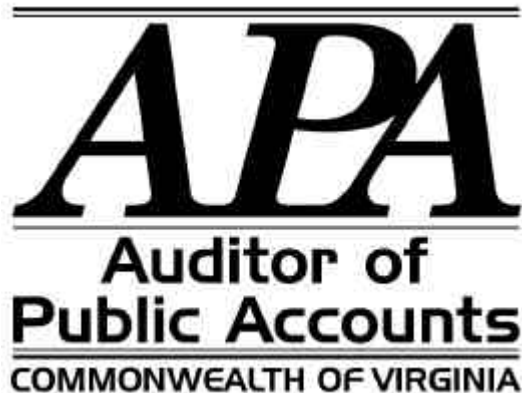


**REVIEW OF THE
DEPARTMENT OF TAXATION
PUBLIC - PRIVATE PARTNERSHIP
WITH
AMERICAN MANAGEMENT SYSTEMS**

RICHMOND, VIRGINIA

**SPECIAL REPORT
MARCH 20, 2002**



EXECUTIVE SUMMARY

Generally, we believe the public-private partnership arrangement between the Department of Taxation and American Management Systems for the development of new systems for Taxation is achieving its goals. Additionally, the Partnership has developed and placed into production the funding streams necessary for completing the project.

A major component of the Partnership is Advantage Revenue, which replaces Taxation's existing STARS system. The Advantage Revenue general design document has experienced some delays that could affect the overall completion date of the project. We believe that properly completing this document is essential to the overall successful completion of the Partnership and Taxation will need to devote additional resources to its completion. Taxation has recognized that having a completed and detailed document before continuing with the project is a critical milestone to the project and spending the time making sure it is correct is an appropriate action with which we concur.

Our other major observation during this review involves the unique nature of the shared management responsibilities of the Partnership. We believe the nature of the shared responsibilities inherent in the Partnership makes it difficult to separate and identify which party causes project delays. As a result, we are concerned that, if ever necessary, Taxation might be unable to effectively determine if AMS' failure to perform caused any delays. In most contractual arrangements, the assignment of responsibilities and duties allows each party to measure and determine if they are fulfilling their part of the contract. This lack of clear delineation of responsibilities and duties might require Taxation to negotiate future contract changes for delays that Taxation did not cause.

To address this observation, Taxation use TRW to provide an independent report of the project status. Taxation could use TRW as an active participant in this process and have them provide the necessary information in their reports on these delays. This process should serve as the basis for Taxation's ability to assist in future contract negotiation with AMS should they be necessary.

Our review has identified an issue that is not a criticism of Taxation's management. The Partnership is one of several system projects recently undertaken by the Commonwealth that rely on either agency charge-backs or a new outside revenue stream to fund the project. The amount of the contract, project scope, and other general financial reviews are outside the normal budgetary and appropriation oversight process. As a result, the projects do not receive the same review and approval process as do other system development projects.

The General Assembly may wish to consider a policy change to the statewide budget process and require all nontraditionally-funded projects be part of the appropriation review and approval process. Enhanced revenue, which is additional tax revenue generated by the system, is funding this project; however, the Appropriations Act does not consider the size and scope of the project. Therefore, as project budget increases occur, there is not the same review process by the General Assembly.

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March 20, 2002

The Honorable Mark R. Warner
Governor of Virginia
State Capital
Richmond, Virginia

The Honorable Vincent F. Callahan, Jr.
Chairman, Joint Legislative Audit
and Review Commission
General Assembly Building
Richmond, Virginia

We have completed our review of status of the Department of Taxation's systems development initiative under a public-private partnership with American Management Systems (AMS) and submit our report.

Scope of Work

To conduct this review, we attended regular weekly project status meetings, obtained the contract and contract changes with AMS, met with members of the Taxation's executive management team, reviewed status reports prepared by TRW, and obtained and reviewed relevant financial information.

Report Content and Observations

Our report contains information about the history of the public-private partnership arrangement with AMS, provides an update on the status of the Partnership, explains the funding model used to pay for the Partnership, and explains contract changes that have resulted in increased costs and project schedule revisions.

A major component of the Partnership is Advantage Revenue, which replaces Taxation's existing STARS system. While the completion of the general design document has experienced some delays that could effect the overall completion date of the project, we believe that properly completing this document is essential to the overall successful completion of the Partnership and Taxation will need to devote additional resources to it completion. Taxation has recognized that having a completed and detailed document before continuing with the project is a critical milestone to the project and spending the time making sure it is correct is an appropriate action with which we concur.

Our other major observation during this review involves the unique nature of the shared management responsibilities of the Partnership. We believe the nature of the shared responsibilities inherent in the Partnership makes it difficult to separate and identify which party causes project delays. As a result, we are concerned that, if ever necessary, Taxation might be unable to effectively determine if AMS' failure to

perform caused any delays. In most contractual arrangements, the assignment of responsibilities and duties allows each party to measure and determine if they are fulfilling their part of the contract. This lack of clear delineation of responsibilities and duties might require Taxation to negotiate future contract changes for delays that Taxation did not cause.

To address this observation, Taxation use TRW to provide an independent report of the project status. Taxation could use TRW as an active participant in this process and have them provide the necessary information in their reports on these delays. This process should serve as the basis for Taxation's ability to assist in future contract negotiation with AMS should they be necessary.

Funding Oversight

Our review has identified an issue that is not a criticism of Taxation's management. The Partnership is one of several system projects recently undertaken by the Commonwealth that rely on either agency charge-backs or a new outside revenue stream to fund the project. The amount of the contract, project scope, and other general financial reviews are outside the normal budgetary and appropriation oversight process. As a result, the projects do not receive the same review and approval process as do other system development project.

The General Assembly may wish to consider a policy change to the statewide budget process and require all nontraditionally-funded projects be part of the appropriation review and approval process. Enhanced revenue, which is additional tax revenue generated by the system, is funding this project however the Appropriations Act does not consider the size and scope of the project. Therefore, as project budget increases occur, there is not the same review process by the General Assembly.

This report is a public record and provides information to the Governor and General Assembly, and the citizens of the Commonwealth of Virginia.

AUDITOR OF PUBLIC ACCOUNTS

KKH/kva
kva: 44

Background

Since its development and implementation in 1983, the State Taxation Accounting and Reporting System (STARS) has been the Department of Taxation's (Taxation) primary revenue accounting system. The system cost \$36 million and addressed the need to process large amounts of business and individual tax accounting data quickly. In 1992, the Joint Legislative Audit and Review Commission (JLARC) advised Taxation to replace STARS when a review revealed significant service limitations and that the system had become technologically outdated. JLARC noted the system was unable to link multiple accounts, avoiding lost revenues for the Commonwealth and could not efficiently provide the computerized management reports Taxation needed.

Public-Private Partnership History

In 1996, the General Assembly enacted legislation to authorize the Tax Commissioner to enter into public-private partnership contracts to finance agency technology needs. Under the public-private partnership, the Tax Commissioner could pay for such services from the increased revenue attributable to the successful implementation of the technology program. The statute required an external oversight group responsible for reviewing and approving the contract terms and the measurement of the new revenue attributable to the technology program.

The external oversight group included Scott Pattison, former Director of the Department of Planning and Budget; Merritt Cogswell, State Internal Auditor; Becky Covey, former staff director of the House Appropriations Committee; John Bennett, former staff director of the Senate Finance Committee; and Bill Landside, former State Comptroller. This external oversight group had no further substantive involvement with the project after approving the revenue measures portion of the contract terms.

The Department of Taxation, with the assistance of the Department of General Services, prepared and released a Request for Proposal document inviting vendors to respond to the creation of the public-private partnership. Taxation received two responsive bids. In July 1998, Taxation contracted with American Management Systems (AMS) forming a Public-Private Partnership (the Partnership).

The scope of the Partnership contract includes the development and implementation of an Integrated Revenue Management System (IRMS). The Partnership consists of two major components, the replacement of STARS with the Advantage Revenue system and the implementation of other initiatives to improve Taxation operations (See Appendix 2 for a detailed list and explanation of all Partnership initiatives). The Partnership contract had an original completion date of July 2003 and an initial cost of \$123 million, of which \$47 million represents the Advantage Revenue system. In setting the scope of the contract, both Taxation and AMS agreed to a methodology for determining the means to measure the growth of revenue for payment under the contract. This methodology would measure revenue growth that resulted from a series of operational changes within Taxation, initiated by AMS, to improve collections.

Partnership initiatives include re-engineering all processes and the replacement of Taxation's entire technology platform. Replacement includes the network infrastructure and WEB-based technologies to link individual taxpayers and businesses with Taxation's employees whether located at the central office, a district office, or working from home. The Partnership would provide a means to better identify new Taxation revenue by improving case management techniques, better audit productivity, improved audit selection and discovery capabilities, and streamlining the collection processes.

The Funding Model

The Partnership systems development uses a self-funded model. There are two parts to this model. First, AMS implemented several initiatives early in the project to generate revenue to pay for the project. These initiatives are efficiency ideas that AMS introduced to increase Taxation revenue collections, known as enhanced revenues. AMS has submitted progress billings to Taxation to pay for the cost of implementing these initiatives and Taxation has paid all of the bills to date.

For the second part of the model, AMS and Taxation are working to implement a new audit module and replace the STARS system with the Advantage Revenue system. There is no significant enhanced revenue expected from this part of the model except for the replacement of the audit module. Taxation believes that the replacement audit module will generate more enhanced revenue by better selecting audit candidates. The initiatives discussed earlier will generate the majority of funding that will pay the AMS progress billings associated with this phase of development.

Currently under the contract, Taxation must use enhanced revenues through fiscal year 2010 to pay AMS the full contract price. If Taxation pays all of the AMS progress billings before 2010, then Taxation can begin depositing the continued enhanced revenue into the General Fund of the Commonwealth. However, if Taxation still has outstanding payments to AMS at the end of fiscal year 2010, then the AMS will forfeit the balance due and Taxation pays no more for the system. Currently, Taxation estimates to pay for the project by August 2005.

Enhanced revenue is determined by comparing a set baseline figure to the benchmark of each revenue initiative. The baseline projects the amount of revenue Taxation would expect to collect if there were no partnership project and calculates the average collections from the preceding three fiscal years. The benchmark is the actual amount of collections generated from or enhanced by an initiative.

The chart below shows the benchmark, baseline, and actual enhanced revenue for fiscal years 1999, 2000, 2001, and part of 2002:

<u>AMS Initiative</u>	<u>Benchmark</u>	<u>Baseline</u>	<u>Opportunity Costs</u>	<u>Enhanced Revenue</u>
<u>Fiscal year 1999</u>				
Write-offs	\$ 1,405,555	\$ -	\$ -	\$ 1,405,555
Delinquency collections	<u>85,439,328</u>	<u>80,516,626</u>	<u>-</u>	<u>4,922,702</u>
Total	<u>86,844,883</u>	<u>80,516,626</u>	<u>-</u>	<u>6,328,257</u>
<u>Fiscal year 2000</u>				
Write-offs	3,418,590	-	-	3,418,590
Delinquency collections	109,367,095	102,133,167	-	7,233,928
Non-filer ID	696,705	-	42,646	654,059
Self audit	32,816	-	10,491	22,325
ABC license comparison	81,944	-	24,150	57,794
Partnerships	275,362	-	5,875	269,487
Estate	-	-	4,059	(4,059)
Miscellaneous	<u>972</u>	<u>-</u>	<u>-</u>	<u>972</u>
Total	<u>113,873,484</u>	<u>102,133,167</u>	<u>87,221</u>	<u>11,653,096</u>

Fiscal Year 2001

Write-offs	\$ 2,714,171	\$ -	\$ -	\$ 2,714,171
Delinquency collections	115,812,873	98,289,459	-	17,523,414
Non-filer ID	(468,595)	-	3,612	(472,207)
Self audit	2,602	-	19	2,583
S-Corporations	588,077	286,868	58,369	242,840
ABC license comparison	47,376	-	7,530	39,846
Field audit	29,780,701	13,033,344	-	16,747,357
Partnerships	18,663	-	-	18,663
Miscellaneous	<u>5,929</u>	<u>-</u>	<u>-</u>	<u>5,929</u>
Total	<u>148,501,797</u>	<u>111,609,671</u>	<u>69,530</u>	36,822,596

Fiscal Year 2002 through December 2001

Write-offs	463,001	-	-	463,001
Delinquency collections	54,451,228	42,908,874	-	11,542,354
Non-filer ID	5,004	-	-	5,004
Self audit	138	-	-	138
S-Corporations	37,641	179,292	2,662	(144,313)
ABC license comparison	15,825	-	-	15,825
Field audit	15,172,844	11,089,038	-	4,083,806
Partnerships	398	-	-	398
Miscellaneous	<u>2,366</u>	<u>-</u>	<u>-</u>	<u>2,366</u>
Total	<u>70,148,445</u>	<u>54,177,204</u>	<u>2,662</u>	<u>15,968,579</u>
Grand Total all years	<u>\$419,368,609</u>	<u>\$348,436,668</u>	<u>\$159,413</u>	<u>\$70,772,528</u>

As shown in the chart above, there are a total of nine revenue initiatives, with delinquent collections, field audit, and write off's representing 99 percent of the enhanced revenue generated as of December 2001.

Revenues generated through the delinquent collections initiative have totaled more than \$41 million and represents 58 percent of the enhanced revenue to date. This initiative uses the STRATA system, which is a decision management tool that uses a risk-based approach to enhance productivity by indicating which accounts have the highest likelihood of collection.

STRATA works with Taxation's Enhanced Collections System and historical STARS information to establish delinquency history for a taxpayer and to recommend appropriate collection techniques. In addition, STRATA sorts work lists to ensure collectors work the more collectible cases first. In December, the Partnership replaced the Enhanced Collection System with the Computer Assisted Collections System for Government (CACSG), which will eventually integrate with the Advantage Revenue system.

The field audit initiative has created \$21 million in enhanced revenue. This initiative involves the identification of the best candidates for a tax audit. To accomplish this, field auditors received new laptops containing software that automates many tasks within their audit plan, making audits more efficient and productive. The Partnership also licensed Trillium software to communicate with external databases like Alcoholic Beverage Control, the Internal Revenue Service, Department of Accounts, Virginia Lottery, and the Virginia Employment Commission to find differences in income and other tax information.

The Partnership is currently developing a new audit module, which when complete will replace the audit module developed as the revenue initiative. The new module will add candidate selection and have

more capacity to hold larger databases of the organizations like the IRS. In addition, this module includes a case management system to allow audit tracking from beginning to end.

As of December 2001 the write-off initiative has generated nearly \$8 million in enhanced revenue. For this initiative, Taxation is using data matching tools developed by AMS to compare its inventory of write-off accounts to payroll information captured by the Virginia Employment Commission. If the system finds a match, then Taxation reactivates the account and issues a tax lien, resulting in collection of the previous write-off amount.

Payments

The enhanced revenue collected is split 90/10 and deposited into two funds. The 90 percent pays the progress billings from AMS. The remaining ten percent pays Taxation's Partnership operating expenses and the TRW billings. If Taxation does not have sufficient funds to pay AMS progress billings, then AMS accrues interest at ten percent of the outstanding balance.

Taxation agreed to pay AMS interest on any interim billing if the Partnership Fund did not have the resources to pay AMS's bill. Taxation adopted this approach to financing, rather than having the interest included within the fixed price of the AMS contract. This approach to interest payments would benefit Taxation if the initiatives generated revenues in excess of the benchmarks or over shorter periods.

Under the original contract terms, 90 percent of enhanced revenue must pay AMS until such time that: 1) AMS has been paid for all progress billings or 2) ten years have expired since the original contract date, after which time AMS will forfeit all outstanding invoices and interest amounts.

As of December 2001, AMS has billed Taxation \$59,260,905, including \$1,075,586 in interest. From August 1999 to December 2001, Taxation has paid AMS \$55,721,421. The unpaid balance of \$3,539,484 is for the December 2001 billing that Taxation paid in January 2002, bringing Taxation current with all progress billings. Following the payment in January 2002, \$4,434,369 remained in the fund to pay future AMS progress billings.

Project Management

There are several layers of project management that oversee the Partnership development. The most detailed layer involves the use of an electronic project management system that describes each project task, responsible person, expected completion date, and dependencies to other tasks. AMS owns this system and their employees provide the expertise on how to use the system and regularly update it. This system provides a useful early warning of uncompleted or delayed tasks and monitors project management.

In the next layer of project management, AMS and Taxation staff, known as Group Leaders, work together overseeing the systems development of their project area. The Group Leaders jointly share responsibilities and work together to resolve issues and make decisions. Each week, all of the Group Leaders meet to discuss the status of their area, determine where issues in other areas may impact their work and timeline, and determine when issues need resolution by a higher management level. The Group Leaders are generally effective in resolving issues and understanding when it is important to notify others about issues.

The highest layer of project management is the P-6 team. This team consists of both AMS and Taxation representatives as shown below.

<u>Taxation</u>	<u>AMS</u>
Bob Schultze, Assistant Commissioner and Partnership Program Manager	Dean Merrill, Vendor Project Manager
Farley Beaton, Business Project Manager	Abdul Quayyum, Project Manager
Linda Foster, Technical Project Manager	Andy Anderson, Project Manager

The Tax Commissioner attends the P-6 meetings. The P-6 team monitors project progress and resolves complex project issues between Taxation and AMS and issues that the Group Leaders cannot solve. For example, the P-6 team is instrumental in deciding when project delays require modification of the project timeline and when additional functionality beyond the initial project scope is desirable.

Due to nature of the Partnership and the shared management and oversight between AMS and Taxation, it is difficult to determine who contributes to project delays. For example, in November 2001, Taxation negotiated a contract change that resulted from project delays and desired system functionality changes. Taxation determined that the delay was the result of several factors equally attributable to both Taxation and AMS. Therefore, both groups negotiated a revised project schedule and increased payments to AMS. While some of the payment increase is a direct result of increased system functionality, there is also a portion that arises from missed deadlines, misunderstandings of responsibilities, and other normal delays that occur on large projects.

The final layer of project management comes in the form of quality control. In April 1999, Taxation hired an external company, TRW, to independently evaluate AMS' progress throughout the Partnership development and has paid nearly \$2 million dollars for this service. TRW reviews the electronic project management system, attends meetings, and issues periodic reports on the various components of the project. The reports include a summary on what has occurred since the last report, a comparison of actual to budget timeline, the effects of delays, recommendations of possible solutions, and an independent assessment of risks.

Project Status

In November 2001, Taxation and AMS negotiated a contract change that moved the Partnership completion date from July 2003 to July 2004 (see section titled "Contract Changes" for more information). As a result, Taxation reworked the project schedule to reflect the revised completion date. As of December 31, 2001, two components of the Advantage Revenue system had fallen six months behind the revised schedule. The schedule incorporates a five-month contingency for delays, which may not provide sufficient time considering the system's complexity and past delays. Additionally, Project Managers have stated that if Taxation misses the completion date, Taxation filing season restrictions will delay the project implementation until July 2004. As a result, Taxation would need to extend the post-implementation phase of the contract with AMS.

TRW's December 2001 Progress Report showed that the Advantage Revenue system replacing STARS had become as much as six months behind schedule. Items TRW cites as contributing to the delay include:

1. The Advantage Revenue general system design document scheduled for completion in September 2001 was still incomplete, pushing it four months behind schedule. The design document delay has occurred because Taxation management has taken longer than planned to review and approve the document. A sound

system design is critical to the project's success because it details the system's functionality.

Early TRW reports warned Taxation that they did not allocate sufficient time in their project schedule to complete the design document. Taxation would have benefited from relying on TRW's recommendation and increasing the time earlier in the project. Now the project schedule has been impacted by this delay and will require modification to not only this task, but also all future tasks that rely on accurate completion date information. As of February 2002, we found that the general systems design document, originally scheduled for completion in September 2001, is now scheduled for completion in April 2002, seven months behind schedule.

TRW's report of January 2002 indicated that although there is a delay in approving the general design document, work is proceeding timely with the Advantage Revenue programming efforts. We believe that without a complete and approved design document, Taxation and AMS risk programming the system's functionality before having a finalized design that could result in wasted resources.

2. The Advantage Revenue conversion of data strategy document scheduled for completion in October 2001 received an extension until December 2001, however management still has not approved the document. This delay pushed the start date of the Advantage Revenue conversion of the data design document back causing a six-month delay from its scheduled completion. The January 2002 TRW report warns that this delay, if not rectified, may impact the planned Advantage Revenue implementation date of October 2003.

Contract Changes

Since signing the contract with AMS for \$123 million, of which \$47 million pertains to Advantage Revenue, Taxation has executed several project altering change orders as described below.

In fiscal year 2000, Taxation exercised three options:

- Develop an automated collections system
- Add Internet filing capabilities
- Change the database technology to Oracle

On November 20, 2001, Taxation and AMS made several contractual changes because of project delays and to increase the system's functionality. The contract changes had the following effects:

- Increased the overall system price by \$17.7 million
- Extended the project completion date from July 2003 to July 2004
- Adjusted the fund retention figures from 90/10 to 70/30. This change will allow Taxation to accumulate \$7.4 million more in their administrative account to pay future operating cost increases, rather than receive increased General Fund appropriations. This change allows Taxation to have \$11 million available for use in funding various parts of the project.

Once Taxation accumulates these monies, the fund split will revert back to 90/10. This essentially takes away funding that would otherwise have paid AMS progress billing and places Taxation at risk of paying more interest payments to AMS. For allowing this change, Taxation agreed to lengthen the payback period from 10 years to 11 years.

- Increased the \$1 million holdback at the conclusion of the contract to \$10 million. Taxation will only pay the holdback after accepting the final product.

The following illustrates the contract price changes resulting from the above change orders:

	<u>Contract Cost</u>	<u>Anticipated Interest</u>	<u>Total Projected Cost</u>
Original contract, July 1998	\$122,857,084	\$17,638,830	<u>\$140,495,914</u>
Adjusted contract price from changes in fiscal year 2001	\$135,548,690	\$ 5,435,553	<u>\$140,984,243</u>
Adjusted contract price from changes in November 2001	\$153,210,690	\$ 8,893,220	<u>\$162,103,910</u>

The total project, including Taxation's administrative costs, will exceed \$213 million. The addition from the ten percent allocation will consist of payments to TRW estimated at \$5 million and other overhead and miscellaneous costs anticipated to be \$13 million. The Taxation will use internal staff to work on the Partnership and anticipates these payroll cost will come from the Department's operational budget and amount to \$33 million. All these items considered bring the total project cost to \$213 million.

Cancellations

The contract details four ways that Taxation or AMS may cancel the contract:

- Cancellation for Convenience
- Cancellation for Non-appropriation
- Cancellation for Cause by Commonwealth
- Cancellation for Cause by AMS

In both the cancellation for convenience and non-appropriation, the Commonwealth can cancel and terminate the contract in whole or part without penalty. Taxation must provide AMS with written notice 60 days in advance. For cancellation for cause by the Commonwealth, AMS has 60 days after receiving a written notice from the Commonwealth to cure the failures or develop a plan. If AMS cannot cure the failures within 60 calendar days, the Commonwealth has the option to terminate the contract. For cancellation for cause by AMS, the Commonwealth has 60 days after receiving a written notice from AMS to cure the failures or develop a plan. If the Commonwealth cannot cure the failures within 60 calendar days, AMS has the option to terminate the contract.

In the instance of cancellation for cause, Taxation must pay AMS for deliverables that they accept and retain. For all other types of cancellations, Taxation must pay AMS for any outstanding invoices,

interest, services rendered that have not been billed by AMS, costs to continue or terminate leases, and all equipment and third-party software that has not been accepted by Taxation, but ordered by AMS.

Impact of Partnership Systems Development on Taxation Staff

Taxation hired ten additional technology staff to work on the Partnership systems development project, as well as using 100 or 13 percent of Taxation staff from various divisions. The remaining 680 Taxation staff continue to work in the various divisions, performing their normal division functions and absorbing the workload of the staff assigned to the Partnership.

Staff working on the Partnership have complained that their performance evaluations continue to use criteria based on their previous responsibilities. Likewise, division staff say they are frustrated at being held to performance criteria that existed when their divisions were fully staffed, making it nearly impossible for them to meet the expectations.

In order to determine whether staff complaints are valid or unfounded, we requested that Taxation provide performance criteria, both before and during the Partnership systems development project, for a sample of staff. Our review of the criteria determined that in all instances the criteria did reflect the staff's work on the Partnership project and that each person received written notification of the revised criteria. Additionally, we found no individual staff position that had any criteria both before and during the project that involved performance measures of an entire division. Individual staff performance criteria continue to consider only individual performance.

Observations

The Partnership is one of the largest system development projects undertaken by a state entity, costing more than \$213 million and taking more than five years to complete. The nature of the public-private partnership between AMS and Taxation makes this undertaking more challenging. The success of the Partnership implementation depends on strong management oversight and control of the project budget and tasks.

The tax filing season affects Taxation's operations from December through June each year, shortening Taxation's opportunity to implement any major system changes. During this season, Taxation will not implement any new system that may disrupt their operations and delay the collection of Commonwealth revenues and refunds to citizens. Taxation has currently scheduled October 2003 as the system implementation date for the Advantage Revenue system (STARS replacement), a time that will cause minimal disruption to operations. If Taxation meets its deadline, AMS will continue to provide technical support through July 2004. Taxation has acknowledged that if Advantage Revenue is not ready by November 2003, they will delay full implementation until July 2004 because of the risk it could have on the coming tax filing season. Taxation would then need to extend the post-implementation phase of the contract with AMS.

We believe the nature of the shared responsibilities inherent in the Partnership makes separating and identifying the causes for project delays difficult. As a result, we are concerned that, if ever necessary, Taxation might be unable to effectively determine if AMS' failure to perform caused the delays. In most contractual arrangements, the assignment of responsibilities and duties allows each party to measure and determine if they are fulfilling their part of the contract. This lack of clear delineation of responsibilities and duties might then require Taxation to negotiate future contract changes for delays that Taxation did not cause.

Such a problem resulted in November 2001 when Taxation negotiated a contract change that resulted from project delays and desired system functionality changes. Taxation determined that the delay was the result of several factors equally attributable to both Taxation and AMS. Therefore, both groups negotiated a

revised project schedule, increased payments to AMS, and increased the contract holdback from \$1 million to \$10 million. While some of the payment increase is a direct result of increased system functionality, there is also a portion that arises from missed deadlines, misunderstandings of responsibilities and other normal delays that occur on large projects.

In response to a mandate by the Council on Information Management, Taxation hired TRW to provide independent reviews and reports on the project status. Although Taxation hired TRW to provide expert oversight, Taxation often questions their observations, which results in delays of the release of their final reports.

We believe that Taxation should rely more on TRW's recommendations, such as the one discussed under the heading, "Project Status, Item 1." In their December 2001 report, TRW identified that the Advantage Revenue general design and conversion strategy documents are currently behind schedule. TRW serves a function similar to a Clerk of the Works on a construction project. The function provides an independent assessment of all parties' performance on a project and can also act to assess which party needs to improve their performance and who is causing delays. In this capacity, TRW is not just a reporter of events to the project team leadership, but to the management of the organization.

We believe that Taxation needs to develop a process for resolving delays and clearly determine the party contributing to the delay. Taxation should make TRW an active participant in this process and have them provide the necessary information in their reports on these delays. This process should serve as the basis for Taxation's ability to assist in future contract negotiation with AMS should they be necessary.

Taxation has reached a critical milestone with the Advantage Revenue general system design document for the Partnership and any further delays could directly affect completion of the largest remaining project component. The general system design document provides the blueprint and needs of the fundamental changes that the Partnership is attempting to undertake. Therefore, while the critical nature of the document requires that it be complete and detailed, it continued delay might require Taxation to negotiate an extension to the existing contracts completion date. Taxation needs to devote the resources necessary to complete this document and continue on with the project.



COMMONWEALTH of VIRGINIA

Department of Taxation

March 22, 2002

Mr. Walter J. Kucharski
Auditor of Public Accounts
P.O. Box 1295
Richmond, VA 23218

Dear Mr. Kucharski:

I would like to thank you for the opportunity to provide the Department of Taxation's (TAX) comments as a part of your office's report on the review of TAX's Partnership Project. As I indicated in my letter to you dated March 19, 2002, the citizens and General Assembly members of Virginia should be provided pertinent and timely facts about the Project. To achieve this goal, I indicated a balanced report that accurately reflected the commitments and achievements brought forth through the Project was paramount. The final report does not contain several key points that I believe are necessary to provide a true status of the Project.

When the Commonwealth and TAX first embarked with this undertaking, one of the conditions of entering into a partnership project arrangement with an outside vendor was a requirement by the Council on Information Management that TAX hire an independent outside organization to perform monitoring and evaluation services of the Project for its duration. Through a competitive process, TAX hired TRW to perform these services. As your report notes, TAX has paid TRW approximately \$2 million since the inception of the Project, and expects to pay TRW a total of \$5 million for the Project engagement.

Contrary to some of the statements in the report, TAX relies very heavily on the advice provided by TRW. For instance, the Partnership's decision to extend the Project schedule was done in part based upon information provided by TRW.

During your office's review, your staff was provided several recent reports from TRW that dealt with the status of the Partnership as a whole and with Advantage Revenue. Your report on the Project indicates that two components of the Advantage Revenue system, the general system design document and the conversion strategy document, have fallen as much as six months behind. However, the TRW report from which this finding is derived (TRW November – December 2001 Progress Report, issued January 16, 2002) states "The AR GSD is more than 98% complete and is not impacting

Mr. Walter J. Kucharski
March 22, 2002
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the schedule of other reliant AR Project activities.” The same TRW report additionally states “The new schedule issued November 6, 2001, referred to as the Partnership IRMS Release, should provide the Partnership Project the additional time to complete all of its initiatives.” TRW’s October – December 2001 Progress Report issued February 13, 2002 addresses the second component and finds that TAX successfully put into place a conversion strategy and a conversion schedule which resolve any possible delays. TRW states “In summary, the new schedule with a one-month extension mitigated the Conversion schedule risk identified in TRW’s last AR Project Progress Report.” In addition, this same TRW report summarized the Advantage Revenue status as timely.

From your report, a reader may falsely conclude that the cost of the Project has gone from \$123 million to \$213 million. As you know, the basis of these two amounts is different. The \$123 million referenced on page three of your report is only the original contract cost with AMS and does not include all the other costs paid for through the 10% Fund and TAX’s payroll costs, which the \$213 million on page nine of your report includes. With a like comparison, the initial cost would be more fairly reported as \$191 million.

I appreciate the reconfirmation from your review that the Project is accomplishing what we set out to accomplish in 1998. As you indicate in the report, the Partnership undertaking is very large and is aimed at bringing TAX’s processes and technology infrastructure into the 21st century. It is aimed at making the Commonwealth a leader in tax administration and maximizing the services provided to our citizens and other stakeholders. To date, the feedback we have gotten from the users of these new processes and infrastructure has been extremely positive.

Again, I appreciate the opportunity to provide the Department of Taxation’s comments as a part of your office’s report on the review of the Partnership Project.

Sincerely,

A handwritten signature in black ink, appearing to read "Danny M. Payne", written in a cursive style.

Danny M. Payne
Tax Commissioner

Appendix 2

<u>Partnership Project Initiative</u>	Status
<p>Fast Track Initiatives – A series of projects intended to provide the revenue stream needed to fund the project.</p> <p>STRATA Collections – A risk management system (STRATA) to prioritize Taxation’s delinquent accounts based on potential for collection.</p> <p>Discovery Audit Programs – New audit initiatives designed to use the latest data matching technology, along with third-party data sources, to discover entities that do not file tax returns.</p> <p>Field Audit Productivity/Selection Tools – New laptops, custom audit software, and software to download accounting data directly from a taxpayer’s system. These tools reduce the time it takes an auditor to perform an audit, increase the number of audits performed annually by auditors, improve the yield from field audits, and reduce the burden audits impose on businesses.</p> <p>Write-off/Lien Program – New data matching tools to match Virginia Employment Commission payroll information to accounts previously written off, allowing Taxation to reactivate the account and issue a third-party lien.</p>	<p><i>Complete</i></p> <p><i>Complete</i></p> <p><i>Complete</i></p> <p><i>Complete</i></p>
<p>Future Vision Blueprint – The Blueprint project provides a view of what Taxation will be in the future and guides the development and design of all Partnership systems and process changes. Identification of a number of opportunities for improving the way Taxation does its work, as well as a number of the strategic initiatives, like Internet applications, that have resulted in significant customer service improvements.</p>	<p><i>Complete</i></p>
<p>Telefile – Allows individual income tax filers with simple returns to file their return by telephone. Allows taxpayers to receive refunds by direct deposit, and make payments by credit card, making the entire return submission paperless and nearly error-free. Taxation received over 160,000 returns for tax year 2000, with an error rate of less than one percent.</p>	<p><i>Complete</i></p>
<p>CACSG (Computer Assisted Collections System) – Replaces an electronic collections system no longer supported by the developing company with a modern collections system. Includes a number of new features such as: self-service payment plans using the telephone (Teleplan), a newly designed correspondence system with hundreds of new letters drafted in plain English, automated generation of liens and lien releases, and laptop functionality for collectors working in the field.</p>	<p><i>Complete</i></p>

Partnership Project Initiative	Status
<p>Channel – A series of projects that use new technologies to completely reengineer the way Taxation processes returns and payments.</p> <p>Lifeworks – Replaces an obsolete key-to-disk data entry system with a new PC Data Entry system in a newly-renovated facility.</p> <p>Redesign of 760 Return – Taxation designed a new individual income tax return and instructions for tax year 2000. The new form reduces the filing burden for most taxpayers and supports automated data captured through the imaging system.</p> <p>Imaging – Installation of an imaging system for the automated data capture, electronic storage, and online retrieval of tax returns and correspondence. Five high-speed scanners capture an image of paper documents. Optical Character Recognition (OCR) and Intelligent Character Recognition (ICR) can “read” tax return information. Images of paper documents are available instantly at the desktop to support customer service, collections, and audit activities. Taxation has processed over 1.3 million returns through imaging since implementation.</p> <p>Corporate Return Imaging – Uses imaging equipment to capture images of corporate tax returns, allowing for the destruction of the paper return and processing utilizing the electronic image.</p> <p>Remittance Processing – Replaces an obsolete check processing system with remittance processing hardware and software fully integrated with the imaging system.</p> <p>Optical Disk Storage for archived records – Utilizes the imaging equipment and software to archive historical return and account information, eliminating the need for obsolete microfilm machines and providing easy access to taxpayer account information.</p>	<p><i>Complete</i></p> <p><i>Complete</i></p> <p><i>Complete</i></p> <p><i>In Progress</i></p> <p><i>In Progress</i></p> <p><i>In Progress</i></p>
<p>Internet Initiatives – A series of Internet applications that provide online services and information to citizens.</p> <p>Web Page Redesign – A newly designed Web Page that includes a new look and makes easier navigation through the content. New computational tools that allow taxpayers to automatically calculate their tax liability without resorting to tax tables and assist married taxpayers in allocating their exemptions and deductions to their best advantage.</p> <p>iFile Business – Allows sales and use, and withholding taxpayers to file their return over the Internet. Taxpayers can also view the past 12 months of account history online, regardless of how the taxpayer previous filed the returns. Returns are nearly error-free and users are allowed to establish an automatic payment schedule if they file early. There are nearly 8,500 businesses registered to use iFile and they have filed over 26,000 returns since implementation.</p>	<p><i>Complete</i></p> <p><i>Complete</i></p>

Partnership Project Initiative	Status
<p>VEC Integration – iFile Business and iReg integrate with the Virginia Employment Commission to allow taxpayers to register or file and pay unemployment insurance taxes at the same time they register or file their taxes with Taxation.</p> <p>iFile Individual – Allows taxpayers to file their individual income taxes over the Internet and make basic changes to their account information. Returns submitted through iFile have a very low error rate and direct deposit ensures timely refunds. All taxpayers can use iFile to check the status of their refund, regardless of whether they filed their return online. Taxation expects to receive over 100,000 returns through iFile during the 2001 tax return season.</p> <p>iReg – Allows new businesses to register online and allows existing businesses to add business locations, consolidate filings, and update address and contact information. Simplifies the registration process by reducing a complex registration form of several pages to a simple interactive paperless application. The system assigns account numbers online, and permits the printing of a sales tax certificate immediately at the business location. Nearly 10,000 new businesses have used iReg to register and over 40 percent of all new businesses now register online.</p> <p>Policy Library – An Internet application that provides access to Virginia tax policy information to the citizens. Taxpayers have accessed over 156,000 policy documents since the Policy Library became available less than a year ago.</p> <p>Secure Messaging – Allows citizens to receive answers to questions about their account in a confidential, secure environment.</p> <p>Extensions/Estimated Payments – Allows individual and corporate taxpayers to request extensions of the filing deadline and make estimated payments over the Internet.</p> <p>Web EFT – Allows taxpayers to pay a tax bill over the Internet, including partial payments.</p>	<p>Complete</p> <p>Complete</p> <p>Complete</p> <p>Complete</p> <p>Complete</p> <p>Complete</p> <p>In Progress</p>
<p>Customer Relationship Management (CRM) – A series of tools that enable a Customer Service Representative (CSR) to provide service to taxpayers contacting the department.</p> <p>Screen Pops and Scripting – The first version of CRM provided “screen pops” and “scripting.” During the routing of an incoming call, the CSR’s computer screen automatically shows the caller’s account information, thereby reducing the time identifying a taxpayer. Scripting provides a set of question and answer trees available to service representatives as a computerized aid in answering questions posed by taxpayers over the phone.</p> <p>Consolidated View – Service representatives and collectors have a consolidated view of the customer that draws key taxpayer information from all subsystems into a single screen that pops up when Taxation receives the call.</p>	<p>Complete</p> <p>Complete</p>

Partnership Project Initiative	Status
<p><i>Integrated Contact Management</i> - Upon receipt, Taxation images all correspondence and faxes from taxpayers and electronically associates this information with the taxpayers account. Service representatives automatically receive all imaged information along with e-mails and secure messages.</p> <p><i>Agency-wide Contact Management</i> –Taxation will convert all correspondence to an electronic image at the time received. Integrated Contact Management will ensure proper routing and timely handling of all agency correspondence.</p>	<p><i>Complete</i></p> <p><i>In Progress</i></p>
<p>Infrastructure Build/Support – Installation and support of the technology tools needed to enable business process improvements.</p> <p><i>LAN/WAN Replacement</i> – Replacement of Taxation’s local area and wide area networks.</p> <p><i>Lotus Notes Rollout</i> – Taxation will upgrade and replace the email system with Lotus Notes, providing many employees with access to a common e-mail system for the first time. Lotus Notes will also provided a document and retrieval management capability that provides important reference materials to Taxation employees.</p> <p><i>Remote Connectivity</i> – Provides the equipment and connectivity necessary for employees in the field to have access to tax systems, images, and e-mail.</p> <p><i>Equipment Rollout</i> – Employees received personal computers, printers, and other equipment to support the new systems.</p> <p><i>Print Shop</i> – Production laser printers and a mail inserter in a new facility allow Taxation to produce professional correspondence.</p> <p><i>Disaster Recovery</i> – A disaster recovery strategy to ensure Taxation technology resources can support critical business operations in the event of a disaster.</p>	<p><i>Complete</i></p> <p><i>Complete</i></p> <p><i>Complete</i></p> <p><i>Complete</i></p> <p><i>Complete</i></p> <p><i>In Progress</i></p>
<p>Advantage Revenue – This core taxpayer accounting system will replace the old and obsolete State Tax Accounting and Reporting System (STARS). Advantage Revenue will employ current technical architecture and software to integrate front-end revenue systems at Taxation. This software application will allow all Taxation employees to access all of the customer-facing systems and will provide opportunities for servicing the citizens.</p>	<p><i>In Progress</i></p>
<p>Auditor’s Toolkit – An audit repository and selection system that will provide new audit functionality. The compliance repository will collect and store all third-party data used in audit selection for matching with Taxation data for use in selecting audit candidates. This system will enhance the audit process by improving information available to auditors, eliminating manual steps in the audit process, and better tracking of audit results.</p>	<p><i>In Progress</i></p>

<u>Partnership Project Initiative</u>	Status
Change Management/Organizational Development Training Project Management	<i>Ongoing</i> <i>Ongoing</i> <i>Ongoing</i>